

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

IN THE MATTER OF THE PETITION OF THE)	
CITY OF PEKIN, a municipal corporation,)	
FOR APPROVAL PURSUANT TO)	Docket 02-0352
735 ILCS 5/7-102 TO CONDEMN A CERTAIN)	
PORTION OF THE WATERWORKS SYSTEM)	
OF ILLINOIS AMERICAN WATER COMPANY)	

SURREBUTTAL TESTIMONY

OF

LETA HALS

INDEX

Witness Identification and Background.....	3
Purpose of Testimony.....	3
Responses to Robert Reilly and Thomas R. Stack.....	3
Response to Randy West, Thomas R. Stack and William R. Johnson.....	15
Response to Mark Johnson.....	16
Response to Frederick L. Ruckman.....	17
Response to Mary Kane.....	20
Response to Terry L. Gloriod.....	24
Response to Rochelle Phipps.....	25
Response to William R. Johnson.....	25
Response to Thomas Q. Smith.....	25
Hals Surrebuttal Attachment 1.....	Reilly Discovery
Hals Surrebuttal Attachment 2.....	Analysis of Sales Transactions
Hals Surrebuttal Attachment 3.....	[CONFIDENTIAL]
Hals Surrebuttal Attachment 4.....	Growth in Earnings
Hals Surrebuttal Attachment 5.....	Sensitivity Analysis – Terminal Value Calculation

1 **Witness Identification And Background:**

2
3 **Q. Please state your name, business address and title.**

4 A. My name is Leta Hals and I am a Manager with Raftelis Financial Consulting, PA
5 (“RFC”), with my business address at 511 East Boulevard, Charlotte, NC 28203.

6 **Q. Are you the same Leta Hals who submitted direct and rebuttal testimony in this**
7 **matter?**

8 A. Yes.

9
10 **Purpose Of Testimony:**

11
12 **Q. What is the purpose of your Surrebutal Testimony in this proceeding?**

13 A. The purpose of my Surrebutal Testimony is to respond to portions of the Rebuttal
14 Testimony of Illinois American’s witnesses Robert Reilly, Thomas R. Stack, Mary Kane,
15 Frederick L. Ruckman, Mark L. Johnson, Randy West and Terry L. Gloriod and portions of the
16 Rebuttal Testimony of Staff witnesses Thomas Q. Smith and Rochelle Phipps.

17
18 **Responses to Robert Reilly and Thomas R. Stack**

19
20 **1. In lines 444-446 of his rebuttal testimony, Mr. Reilly indicates that Ms. Hals confused**
21 **his independent income analysis and that he has presented an independent analysis.**

22 **What is your response?**

23 Mr. Reilly claims that he “presented” an independent analysis, and implies a presentation of an
24 independent income analysis in his direct testimony. No such analysis was presented, but merely
25 the conclusions of such analysis. In response to discovery requests to produce all models,

schedules, and/or source documents used to develop his income analysis, however, Mr. Reilly “presented” such income analysis to Pekin. (a copy of the produced income analysis is attached as Hals Surrebuttal Attachment 1)

2. After reviewing Mr. Reilly’s income analysis (Hals Surrebuttal Attachment 1), have you determined why your valuation result differs so greatly from his \$66.6 million result?

Mr. Reilly uses investor-owned revenues, municipal expenses, and municipal cost of capital in his income analysis. He is, in essence, picking those assumptions and data points that will give him the greatest value under the income analysis, which leads me to question his independence and objectivity in his analysis. I base my revenue stream on the revenue requirements of the most likely purchaser, an investor-owned utility. Mr. Reilly does not base his municipal revenues on municipal revenue requirements, but instead on a totally unrelated number, the revenue requirements of an investor owned utility.

Just because a municipality is not regulated does not mean that it will set rates at whatever levels it desires. Mr. Reilly even testifies, “most municipalities operate utilities on a break even basis.” (Line 384) Since he believes that the most likely purchaser of the Pekin system is a municipal entity, he should then use the most likely revenue stream of that municipality, which by his own admission would be revenues that equal revenue requirements.

3. Mr. Reilly repeatedly argues that your analysis does not constitute a proper appraisal (lines 19-22). Mr. Stack says that Illinois-American has presented “convincing evidence” to this regard (131-132). What is your response?

My analysis is consistent with valuation standards and provides an ascertainable market value for the Pekin System. Mr. Reilly, however, specifically addresses the reasons that he believes that my analysis does not constitute a proper fair market appraisal (lines 38-99), which I will address.

Mr. Reilly accuses Raftelis Financial Consulting (“RFC”) of performing a “investment valuation” rather than a “market valuation”, simply because RFC’s analysis uses Illinois American Water Company’s (Illinois-American) allowed rate of return instead of an “independent analysis” of the appropriate present value discount rate. In this same regard, Mr. Reilly (lines 461-467) also criticizes my failure to perform a cost of capital analysis separately for the Pekin system.

Since I believe that the most likely buyer would be a private investor, I believe that using the Illinois-American allowed rate of return as a proxy for the appropriate rate of return for the Pekin system is a reasonable assumption. Furthermore, I have performed a sensitivity analysis of RFC’s Alternate analysis (presented in my rebuttal testimony), and as I demonstrate in the following table, changes in the rate of return and discount rate do not materially affect the value of the system.

Table 1 – Sensitivity of Income Approach Valuation based on Changes in Pekin System Weighted Average Cost of Capital (“WACC”) (Rate of Return and Discount Rate)

Scenario – Alternate Analysis	Value
WACC = 7.38%	\$11.9 million
WACC = 5%	\$11.8 million
WACC = 10%	\$12.1 million

68 Mr. Reilly also indicates that I have ignored the cost approach in my valuation of the system.
69 This is not the case. Instead of “ignoring” the Reproduction Cost New Less Depreciation
70 (“RCNLD”) method as he claims, I considered it and subsequently rejected it. The definition of
71 fair market value requires the individual valuing the entity to consider it from both the willing
72 buyer and willing seller perspective. To the extent a valuation method is not appropriate for
73 either the willing buyer or the willing seller, then that valuation method can be excluded. A
74 willing hypothetical private buyer would rarely, if ever, pay RCNLD for a regulated utility since
75 it is highly unlikely it could include that full investment in rate base. Further, a municipality
76 would never pay RCNLD because the resulting rate impact on customers would be significant.
77 Therefore, whether the willing hypothetical buyer is either an investor-owned utility or a
78 municipality, RCNLD would not be appropriate. In this case, it can be argued that another asset-
79 based approach would be considered.

81 Mr. Reilly also contends that because I do not believe the Pekin system is “special use” property,
82 that I have not performed a proper appraisal. The issues of special use and the methodology for
83 performing a market approach valuation analysis are completely separate. There is a readily
84 ascertainable **market value** for the assets in question. Mr. Reilly, himself, states that there are
85 three methods for determining fair **market value**: the income, market, or cost approaches. The
86 fair market value of the assets of the system can be readily ascertained, as I have demonstrated in
87 my analysis.

89 As to my market analysis (that I use as a “reasonableness check”), Mr. Reilly criticizes it in lines
90 139-158, on the basis that I did not perform a comparability analysis. Mr. Reilly goes further in

line 128 and references my response to data requests, to then state that I did not do “any” research on the companies submitted in Attachment A and B of my rebuttal testimony. While those were my responses based on the way the discovery questions were posed, I was answering that I had not performed a comparability analysis in terms of condition, expected growth, source of supply, etc. After reviewing Mr. Reilly’s discovery (Hals Surrebuttal Attachment 1), while the analysis I performed for my reasonableness check was not as extensive, many of the points used by Mr. Reilly were also included in my reasonableness check as noted in my rebuttal testimony. As demonstrated in Table 1 of my rebuttal testimony, and similar to Mr. Reilly’s development of pricing multiples as shown in Hals Surrebuttal Attachment 1 (Bates No. 02440), I did compare the transactions to the Pekin System in terms of the following:

- Number of customers;
- Date of utility transaction;
- Net utility plant;
- Revenues;
- EBITDA (Earnings before interest, taxes, depreciation, and amortization);
- EBIT (Earnings before interest and taxes); and

The only other points included in Mr. Reilly’s development of pricing multiples were comparisons of debt free net income and debt free cash flow.

Also, in some respects my analysis is more on point for the Pekin system. For example, many of Mr. Reilly’s transactions are for systems much larger than the Pekin system (up to 90 times larger in terms of net book value). Hals Surrebuttal Attachment 2 demonstrates how my figures in my “reasonableness check” are more comparable than those he selected in his “market

approach” analysis. His analysis appears to be the data upon which he bases his opinion that there is no comparable transaction data for the Pekin system. Based on the transactions that Mr. Reilly selected, it does not appear that he attempted to perform a thorough search of transactions in Illinois (as presented in Hals Rebuttal Testimony, Attachment A) and surrounding states. It also demonstrates his bias, and calls into question his conclusion that there is no market and his market approach valuation of \$35.5 million.

In fact, Mr. Reilly must have believed that the financial analysis of his noted market transactions that he performed had some relevance to the Pekin system since he weighted it 10% in his Fair Market Value Summary (Hals Surrebuttal Attachment 1, Bates No. 02425). Therefore, by his own analysis, the water industry market has relevance to the Pekin system. This exhibit also demonstrates that Mr. Reilly was inconsistent in his testimony when he says that he did not rely on his market analysis in his fair market value estimation (165-166). Thus, considering Mr. Reilly’s choices for his market approach analysis and the fact that he used this approach in his fair market valuation, it has not been proven that there is no comparable transaction data that would allow for a market approach to valuation to be performed for the Pekin system.

Mr. Reilly also criticizes me for not comparing the properties that I discuss in my rebuttal in terms of condition, expected growth, source of supply, investment risk, etc. However, this testimony seems to be inconsistent with his analysis since I do not see discussions in his discovery that compare Pekin to his selected transactions on these points.

136 In addition, Mr. Reilly is incorrect in implying that I had not researched these transactions well
137 enough to know that they were part of larger acquisitions. I was aware of this fact, but I believe
138 that it can be argued that, even though my transactions were part of larger transactions, data for
139 several of these transactions may still be considered relevant to the Pekin system. At the very
140 least, the comparability of similar sales is typically decided during condemnation proceedings.

141

142 **4. At line 210, Mr. Reilly indicates that the fact that Illinois-American management does**
143 **not use the RCNLD method in determining the value of acquired water utilities should**
144 **not have an impact on a fair market value appraisal. What is your response?**

145 I do not necessarily believe that it should impact the valuation analysis, but it does support my
146 earlier testimony that it is highly unlikely that a willing hypothetical private buyer would be
147 willing to pay a price established through RCNLD methodology for a regulated utility. I also
148 think that it is interesting that in examples of where Illinois-American was a willing buyer,
149 negotiating with a willing seller, that they did not consider RCNLD as an appropriate valuation
150 method.

151

152 **5. In lines 235-237, Mr. Reilly states that you admit that you have not performed a fair**
153 **market value analysis. Is this true?**

154 This is not true. Mr. Reilly appears to ignore the valuation analysis submitted and discussed in
155 my Direct Testimony in addition to my feasibility analysis. An income approach, as provided in
156 my valuation analysis, is an acceptable method to establish fair market value in Illinois. As for
157 Mr. Reilly's claims in these same lines that I failed to perform an RCNLD analysis, for reasons I
158 stated previously, RFC considered RCNLD, but decided not to perform an RCNLD analysis

because it is highly unlikely that it would be an approach considered by a hypothetical willing buyer. However, one cannot use this to draw the conclusion, as Mr. Reilly attempts to, that we have not performed a fair market value analysis.

6. In lines 241 - 243, Mr. Reilly states that you have failed to consider the transaction from the willing buyer/willing seller perspective? What is your response?

Mr. Reilly states that by ignoring RCNLD, I have failed to consider the sole method for valuing “special use” property. As I previously stated, there is a readily ascertainable market value (i.e., income approach) for the Pekin system, and therefore, the system should not be considered “special use” property. Therefore, this argument is not valid. Furthermore, there is a viable market for water systems, as demonstrated in my rebuttal testimony.

Mr. Reilly also implies that a purchaser would be able to recoup its investment on RCNLD if the purchaser were a municipality. First, I do not believe that the most likely purchaser is a municipality, as I have already testified (Hals Rebuttal, lines 269-286). Second, I do not believe that a municipality would be able to recoup its investment if it were to pay RCNLD since it would be forced to pass an unfair burden on to the ratepayer.

Mr. Reilly also questions my assertion that that there can be variances in calculating RCNLD since engineers can reach different conclusions. Even he admits in his testimony that engineers can reach different conclusions using the same methods (lines 272-274). Further, one must question the results of the RCNLD presented by Mr. Reilly when compared to the RCNLD analysis that was performed by Illinois-American in 1997 and updated in 1999 that estimated the

value of RCNLD at between \$34 million and \$40 million (other values calculated in this study ranged between \$17 million and \$19 million) (Hals Surrebuttal Attachment 3). Although Illinois-American has tried to say that this was not an RCNLD analysis, Mr. Ruckman called it an RCNLD analysis, and it was labeled as an RCNLD analysis in the report itself. I would agree that the 1999 RCNLD analysis uses a different methodology than used to establish the value advocated by Mr. Reilly, but the 1999 RCNLD analysis points out the fact that it is not unreasonable that a different engineer may come up with a value much closer to \$34 million, and thus a totally different RCNLD analysis than relied upon by Mr. Reilly.

7. Again, Mr. Reilly states that you have equated value with rate base. What is your response (lines 318-319)?

As I have extensively stated in my rebuttal (Hals Rebuttal, lines 213-229), the only link between rate base and value is due to the regulatory nature of this industry, and does not invalidate my analysis.

8. Mr. Reilly contends at line 323 that you are “fundamentally in error from an appraisal perspective.” What is your response?

This disagreement between Mr. Reilly and myself does not constitute a “fundamental error” as he claims. First, as presented in previous testimony, I disagree that the appropriate assumption regarding ownership for performing the income valuation analysis is to assume a municipal entity as the hypothetical buyer. I also find it interesting that although Illinois-American is contesting the feasibility of the City acquiring the Pekin system, its own witness uses the

economic benefits of municipal ownership to support his testimony (Reilly Rebuttal, lines 347-352).

9. In lines 358-439, Mr. Reilly points out errors in your testimony and revised income capitalization analysis. What is your response?

As to rate moratorium, Mr. Reilly must be confused here. There was no rate moratorium in my income capitalization analysis. The rate moratorium is incorporated into my analysis of the feasibility of Pekin acquiring the system. Since it is the intention of Pekin to have a rate moratorium, then it is prudent that I include this fact in my analysis.

As to cash-needs financing, as I have previously stated, Mr. Reilly uses investor-owned revenues, municipal expenses, and municipal cost of capital in his income analysis. By picking those assumptions and data points, he significantly increases the value in his income analysis, which leads me to question the independence and objectivity of his analysis. I base my revenue stream on the revenue requirements of the most likely purchaser, an investor-owned utility. Those revenue requirements are based on the rate base, which is consistent with how an investor-owned utility establishes revenue requirements and resulting revenues. While Mr. Reilly testifies that “most municipalities operate utilities on a break even basis” (Line 384), he then ignores this fact when establishing the revenue stream for his “most likely buyer” in his income analysis. Since he believes that the most likely purchaser of the Pekin system is a municipal entity, he should then use the most likely revenue stream of that municipality, which by his own admission would be revenues that equal revenue requirements.

227 I agree that there is an “economic benefit” to municipal ownership as he states in lines 392-393,
228 and I also believe that “economic benefit” should be passed on to the ratepayer and not kept for
229 the profit of the utility itself. As I have previously testified (Hals Rebuttal, lines 242-253), this is
230 supported by American Water Works Association’s (“AWWA”) M1 manual.

231

232 As to understated cash flow, since I do not believe that the most likely hypothetical buyer is a
233 municipality, then it is not appropriate for me to adjust for property and income taxes.

234

235 As to improper discount rate, I stand behind my decision to use Illinois-American’s rate of return
236 as a proxy for the appropriate rate of return for the Pekin system. As previously indicated, the
237 sensitivity analysis shown in Table 1 (line 67) supports this position.

238

239 **10. In lines 452 – 453, Mr. Reilly contends that his corrected analysis demonstrates the**
240 **dramatic impact that your analytical errors have on your valuation conclusion. Do you**
241 **have a response?**

242 Yes. The “analytical error” that has a dramatic impact on my valuation conclusion that he is
243 referring to is that I perform an income analysis under an investor-owned ownership scenario.

244 At worst, this is a difference in opinion between myself and Mr. Reilly, not an analytical error.

245

246 What is, however, an analytical error is Mr. Reilly’s use of the revenues from one ownership
247 structure (investor-owned) and the expenses from another ownership structure (municipal) to
248 estimate free cash flow or distributable income. This is an analytical error that he performed in
249 both his analysis submitted with his testimony and his “independent income analysis” he refers

to line 445 of his Rebuttal Testimony (Hals Surrebuttal Attachment 1 – Bates No. 02441-02448).

The result of this error is extremely material in terms of valuing the Pekin System.

11. In lines 479-487, Mr. Reilly appears to criticize RFC for performing an economic feasibility of the City acquiring the Pekin District as he asserts it does not represent fair market value. What is your response?

In performing an economic feasibility analysis, an estimate of value must be determined. To do so, I considered many methods of valuation. As I have testified, it is my belief that the income analysis is the most appropriate for establishing fair market value in this instance. Therefore, while presenting the economic feasibility analysis was one objective, establishing the fair market value of the system using an income approach was also one of my objectives. Just because I do not agree with Mr. Reilly's opinions on special use property and the appropriateness of his assumptions, does not mean that I did not perform a fair market value analysis.

12. Mr. Reilly, at lines 501-516, states that the Gordon Growth model is the most common procedure in estimating terminal value in an income approach. He also states that you do not "understand the accepted valuation practice regarding this integral component of the income approach analysis." What is your response?

One of the primary requirements in using the Gordon Growth model is that the analyst must project a constant growth in distributable earnings into perpetuity. Inherent to using this model is the requirement that this growth factor is expected to be constant. One way to determine if distributable earnings can be expected to be constant is to look at the consistency in the growth of projected distributable earnings over the projection period. In all the analyses that have been

presented either by myself or Mr. Reilly, none of the growth in projected earnings is constant over the projection periods. In fact, there have been dramatic swings. See Hals Surrebuttal Attachment 4 for a demonstration of these facts. For these reasons, I do not believe that it was unreasonable to literally project the earnings until the present value reaches zero.

This notwithstanding, I have performed a sensitivity analysis (presented in Hals Surrebuttal Attachment 5) using the growth in distributable earnings used by Mr. Reilly in his “independent” income analysis. I do not believe that this growth factor is appropriate for use in my analysis, but I would like to demonstrate that applying this methodology does not explain the differential between the valuation results of our analyses.

Based on this analysis, the resulting value would be \$15.7 million using Mr. Reilly’s assumptions for terminal value. Applying this value to the feasibility analysis results in the ability for the City to not raise rates for at least 10 years.

Response to Randy West, Thomas R. Stack and William R. Johnson

13. In lines 65-68 of Mr. West’s testimony, he implies that the City will put less priority on capital improvements outside the City as compared with those inside the City. Mr. Stack and ICC staff (William R. Johnson – lines 77-91) echo similar concerns. Do you have a response?

I think that it is important to note that outside City customers constitute less than 10% of the total Pekin system customer base. Based on RFC’s rate setting experience, it would not be worth the

City's time or money to try to set a rate differential between outside and inside City customers to generate additional revenues since outside City customers constitute such a small portion of the customer base.

In addition, RFC has seen several instances where policies have been successfully enacted to treat inside and outside City customers equally. A prime example this would be the Charlotte-Mecklenburg Utilities Department ("CMUD"). CMUD has established policies to guarantee the equality of inside and outside city customers where outside city customers are comprised of six municipalities, as well as other incorporated areas of Mecklenburg County.

Response to Mark Johnson

14. In line 159, Mr. Johnson states that you have been inaccurate and misleading with regard to the discrepancy between projected and actual capital improvements. What is your response?

At no time have I been inaccurate or misleading. It is clear, both in direct and rebuttal, that I was comparing RFC projections to Illinois-American investments. I have never made a comparison to Illinois-American's Comprehensive Planning Study .

15. In lines 205-207, Mr. Johnson states that the City has not developed its own capital improvement plan. Mr. Ruckman makes the same assertion in his testimony (lines 326-331).

Mr. Johnson goes to great lengths in lines 145-148 to describe Illinois-American's "meticulous comprehensive planning process." Since Illinois-American testifies that it put so much planning and effort into their plan, I do not believe that it is unreasonable that the City would use this plan as a starting point. Since Illinois-American's numbers are so close to depreciation, however, I believe that the Illinois-American plan would be just that, a starting point.

Response to Frederick L. Ruckman

16. Does Mr. Ruckman fully explain the series of events related to obtaining Illinois-American capital improvement information in response to Question 23?

No. Illinois-American's capital plans were deemed to be confidential by Illinois American in September, and Illinois-American would not produce until a Non-Disclosure Agreement was executed. This Agreement was not negotiated and finalized until either January or February, but well after my direct testimony was due.

17. In lines 295-296, Mr. Ruckman states that you "assume that the value of the system and original cost rate base are the same." Is this statement true?

As I have testified in my rebuttal testimony (Hals Rebuttal, lines 213-229), I do not estimate the value of the system at original cost rate base. I have performed an income approach valuation analysis that projects the future earnings potential of the system. The fact that this number is close to rate base is simply due to the regulatory nature of the industry, and does not invalidate my methodology.

341 **18. In lines 296 and 297, Mr. Ruckman states that you “contend that the Pekin System is**
342 **worth approximately \$2 million less than even its current base”. What is your**
343 **response?**

344 Given that my original testimony was presented last fall, I originally valued the system at the end
345 of December 31, 2002. The rate base in my revised testimony at the end of December 31, 2002
346 was \$11.5 million as compared to a value of \$11.9 million. According to Schedule B-2, Exhibit
347 number 11 Page 6 of 9 in the Illinois-American 2002 Rate Case (Docket #02-0690), the 2001
348 actual rate base was \$11.6 million, and the projected 2002 rate base was \$11.8 million.

349 Therefore, Mr. Ruckman is inaccurate in his statement that I contend the Pekin System is worth
350 \$2 million less than its current base.

351
352 The reason for the drop in the value of the system between my original and alternate analyses is
353 due to the significant drop in the capital improvement assumptions when implementing actual
354 numbers from the Illinois-American Comprehensive Planning Study into my analysis. It makes
355 sense that if Illinois-American makes fewer capital improvements than I had projected in my
356 direct testimony, then it has a smaller rate base on which to earn a return, thereby decreasing its
357 earning potential over time.

358
359 **19. In response to Question 25, Mr. Ruckman states that you ignore the cost that would be**
360 **associated with Pekin’s acquisition of the system, as well as ignore the loss of economies**
361 **of scale provided to Pekin.**

362 As I have previously testified, I believe that I have more accurately estimated the value of the
363 Pekin system, and have demonstrated the unreasonableness of the RCNLD number in relation to

364 typical water utility market transactions. In addition, I do not believe that Mr. Ruckman's
365 estimates regarding O&M cost increases under City ownership are valid. First, even though the
366 City has not selected a contract operator, it is still very likely that such selected contract operator
367 would enjoy similar economies to the Pekin District of Illinois-American. In fact, I believe it
368 would have been unreasonable for the City to send out an RFP and select an operator when the
369 Commission has not yet ruled on the whether the City can move forward with the condemnation,
370 and that the timing of the acquisition will occur at least a year from this point in time, if not
371 longer.

372
373 Second, economies of scale only go so far in reducing cost. Cost savings do not rise
374 proportionally to the size of the negotiating company. At some point, the savings will approach
375 an amount beyond which a supplier will not go because it will not be able to earn a profit.

376
377 Third, I have not reviewed testimony where Mr. Ruckman specifically established where Pekin
378 has benefited from their economies of scale. Instead, he just makes generalized statements on
379 this issue.

380
381 **20. What is your opinion of Mr. Ruckman's analysis presented in Questions 27 through 31**
382 **and Exhibits 2.2R and 2.3R?**

383 I do not believe the purchase price determined by Mr. Reilly is valid and I do not believe that the
384 O&M projections presented by Mr. Ruckman are likely. Therefore, I believe that Mr.

385 Ruckman's analysis does not accurately reflect the feasibility of Pekin acquiring the water
386 system.

387

388 In addition, as stated in my rebuttal testimony (Hals Rebuttal, lines 485-495), I performed a
389 sensitivity analysis where Mr. Ruckman's O&M projections were considered. RFC determined
390 that under the alternate economic analysis demonstrated in Attachment C of the rebuttal
391 testimony, the City could experience a 12.3% increase in capital costs (Ruckman, original
392 testimony Lines 265-267) and a 22% increase in O&M costs, and still maintain a five year rate
393 freeze. If the City were to experience a 25% increase in O&M costs as suggested by Mr.
394 Ruckman (derived from Ruckman's original testimony Lines 209-278), the City would need only
395 a 3% rate increase in the fifth year to cover revenue requirements.

396

397 As a result, this analysis indicates that, even if RFC agreed with all alternate assumptions offered
398 by Illinois-American experts to the RFC income analysis, the acquisition of the system is
399 economically advantageous to the customers of the system since rates over time would be
400 significantly lower under municipal ownership than under Illinois-American ownership.

401

402 **21. In lines 417-418, Mr. Ruckman refers to the "adverse effect of Pekin's proposal" on the**
403 **customers outside the Pekin District. What is your response?**

404 Since the Pekin District has its own stand-alone rate, the only costs that would impact other
405 customers of Illinois-American would be the common costs of the entire system. Since Pekin's
406 operating revenues constitute only 3.40% based on its present rates (or 2.94% based on its

proposed rates) as compared to the total Illinois-American operating revenues , the net impact on other customers should be immaterial.

Response to Mary Kane

22. In her response to Questions 4 and 6, Ms. Kane again questions whether or not the Pekin water system will be self-sustaining under City ownership. What is your response?

RFC's feasibility analysis is and has always been clear on this issue. There are no grants or City reserves in my analysis used for supporting rates or finances of the water system. There are no inconsistencies in my testimony. I have always stated that RFC's feasibility analysis is self-supporting.

My only purpose at page 12, lines 23-24 in my direct testimony was to point out that (1) grants may become available that would even further improve the feasibility of acquisition; and (2) the City's reserves exist and should give the ICC comfort that they could be accessed in the unlikely event of any major financial difficulties. An analogy to Illinois-American would be a line of credit that it may have at a bank. One would not say that Illinois-American is not self-sustaining just because they have a line of credit at a banking institution, but realize that they have access to funds if necessary.

428 In addition, Ms. Kane refers to “Ms. Phipps’ confusion” in lines 433-435. There was nothing
429 confusing about my analysis. Ms. Phipps could look at my analysis and see that I showed no
430 external cash stream entering the fund balance for the water system.

431

432 Again, it is my understanding that the intentions of the City are to operate the water system on a
433 self-sustaining basis. My analysis shows that this is not only feasible, but it is also in the best
434 interest of the public since rates would be lower under City ownership as compared with
435 continued Illinois-American ownership.

436

437 **23. In response to Question 5, Kane testifies that a rate freeze would require deferral of**
438 **spending for capital programs. Other individuals presenting testimony make similar**
439 **statements (Stack – lines 315-326). What is your response?**

440 I have already testified in detail regarding concerns with the accuracy of Illinois-American’s
441 valuation. Further, in my analysis, there is no deferral of spending as a result of the rate freeze.

442

443 **24. In response to Question 7, Ms. Kane bases her testimony of Standard & Poor’s (“S&P”)**
444 **assessment of double-barreled bonds. What is your response?**

445 Ms. Kane is completely confused. It has never been my or the City’s assumption that double-
446 barreled bonds would be issued. None of Piper Jaffray’s assumptions regarding issuance costs,
447 interest rates, etc. have been based upon the assumption that the City would use double-barreled
448 bonds.

449

450 While the City has stated its intent to operate the water system as a self-supporting enterprise
451 fund and will, as a result, want to operate it in a way that provides enough revenue to service the
452 debt, S&P will not require a "covenant to raise rates to ensure that it has projected coverage prior
453 to the initial bond issue and maintain that coverage throughout the life of the issue". The 1.25
454 times coverage factor referenced in line 116 of Ms. Kane's testimony would also not be required
455 by the rating agency or investors. Because the bonds will be general obligation bonds, the City
456 will be relied upon to operate the system in a manner that assures that debt service is paid, not in
457 a manner that results in an arbitrary coverage of debt service.

458

459 Ms. Kane's statement in lines 447-448 that if the rating analyst had "considered the potential of a
460 \$65 million future debt issuance..., the City's (2003) bonds might well have been rated below
461 investment grade" is ludicrous. No rating analyst would downgrade significantly (and most
462 likely not at all) on the basis of a potential borrowing for an essential purpose, revenue producing
463 enterprise for which the cost has not been determined.

464

465 As to number 3 on lines 80 and 81, as stated previously, there is no question as to whether or not
466 the utility will be self-supporting.

467

468 This notwithstanding, RFC's Alternate analysis presented in my rebuttal testimony consistently
469 demonstrates a coverage of 1.25 or higher. Therefore, it is not difficult for Pekin to meet the
470 standards described by Ms. Kane.

471

472 **25. In lines 130-140, Ms. Kane indicates that calculation of coverage is debatable. What is**
473 **your response?**

474 As previously testified, there is no bond coverage requirement for GO Bonds. However, even if
475 such a coverage requirement existed, Ms. Kane's calculation would be incorrect. Ms. Kane
476 refers to the items excluded from the coverage calculation as "repairs" and "essential
477 maintenance". Capital expenditures are neither repairs nor maintenance. Repairs and
478 maintenance are typically incorporated into the O&M costs, which are included in RFC's
479 coverage calculation. "Revenue-financed capital expenditures" are just that, capital expenditures
480 that are funded from revenues. They could just as easily be funded from fund balances from
481 previous years or debt service (if coverage is adequate). My purposes for showing them as
482 revenue funded was just to prove that there were enough revenues left over each year to make
483 these improvements. This approach to financing further demonstrates the strong financial
484 strength of the Pekin system under City ownership.

485
486 **Response to Terry L. Gloriod**

487
488 **26. Mr. Gloriod indicates that the common equity return of Illinois-American is only one**
489 **component of the cost of capital for Illinois-American (lines 269-270). What is your**
490 **response?**

491 He is correct, but that "one component" comprises more than 45% of Illinois-American's capital
492 structure. In addition, the rate of return on equity is more than 11%, which is significantly higher
493 than Illinois-American's cost of debt.

495 **27. Mr. Gloriod indicates that you ignore all the benefits and efficiencies of the American**
496 **system (lines 270-272).**

497 Since Mr. Hierstein answered this assertion, I did not ignore this fact. In addition, I believe that
498 the City of Pekin would continue to enjoy the benefits, efficiencies, and expertise of a seasoned
499 water operator if they hire a contract operator to run their system

500
501 **28. Mr. Gloriod refers to your “puzzling testimony” regarding the mystery of the owner of**
502 **the system (lines 278-280). What is your response?**

503 The mystery of ownership refers to the fact that the ultimate owner is not Illinois-American
504 (headquartered in Belleville, IL), nor its parent American Water Works Company (“AWWC”)
505 (headquartered in Voorhees, New Jersey), nor AWWC’s parent, which is Thames Water
506 (headquartered in Swindon, UK), but ultimately RWE, AG (headquartered in Essen, Germany).

507
508 **Response to Rochelle Phipps**

509
510 **29. Ms. Phipps testifies that “Pekin’s implied credit strength is sufficient...if the City**
511 **acquires the Pekin District for a purchase price that allows the City to issue GO Bonds**
512 **totaling less than \$26,000,000 (lines 237-240). What is your response?**

513 It is my understanding from conversations with Piper Jaffray that the benchmarks used by Ms.
514 Phipps are benchmarks that S&P considers when rating bonds. These benchmarks are not set
515 criteria that must be met to achieve a certain rating. Furthermore, the City has the opportunity to
516 present its case before the rating agencies before a rating is provided. Given that three of the
517 four data points used by Ms. Phipps are quite low for the \$12-14 million price, and since S&P
518 does not consider a high rating in one or two of the benchmarks to necessarily be a “deal-killer,”

519 it is likely that S&P will not be overly concerned about the City's total debt burden if the
520 ultimate system value is much higher than \$26 million.

521

522 **Response to William R. Johnson**

523

524 **30. Mr. Johnson expresses concern about the City treating customers outside the City**
525 **limits equitably with customers inside the City limits (lines 77-91). Do you have a**
526 **response?**

527 Mr. Hierstein has responded to this concern.

528

529 **Response to Thomas Q. Smith**

530

531 **31. Mr. Smith testifies that your and Mr. Ruckman's analyses cannot be relied upon**
532 **because they forecasts financials into the future (lines 71-76 and 112-115). What is your**
533 **response?**

534 Most companies rely on financial forecasts for budgeting, planning, and predicting future
535 feasibility. Although no one can predict the future, it is better to use the best assumptions
536 possible to forecast financial sustainability than to do nothing at all. The only way to
537 demonstrate the financial viability of the City acquiring the Pekin system is to forecast financial
538 data for the system. I would agree that the figures in my analysis in the initial years are more
539 reliable than the years further out in the future. However, I also believe that the analysis presents
540 a materially accurate picture of the financial feasibility of the acquisition. If Mr. Smith's
541 reasoning were to be used, then no municipality would have the right to condemn the system,
542 despite feasibility, just for the simple fact that no one can predict the future.

543

544 As to Mr. Smith's concern about Pekin not having a specific contract operator selected at this
545 point in the process (lines 82-84), see my response to Question No. 19.

546

547 32. Does this conclude your testimony?

548 Yes.

549